FSLG NEWSLETTER
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MESSAGE FROM THE EDITOR: FORM 941
BY STEWART ROULEAU, SENIOR FSLG ANALYST

As we reported in our previous edition, Form 941, Employer's Quarterly Federal Tax Return, is undergoing a major revision for 2005. The IRS has redesigned the form in an effort to ease taxpayer burden, make processing more efficient, and to reduce filer errors. The new form will be used for the first quarter of 2005. In this article, we want to let you know about some specific changes you will see on the form.

1. Form 941 will now be optically scannable. This will make it easier to process and should reduce the situations in which the IRS needs to contact you about an error.

2. The form is two pages, printed front to back. You will need to be sure to enter your identifying information at the top on the back. The expanded format should make the form easier to read and complete. Different sections are clearly identified.

3. All income tax, social security and Medicare adjustments can now be reported on line 7. There are separate sublines (7a through 7g) for different types of adjustment. There are new lines for "special adjustments" resulting from correcting prior period payments for misclassified workers. In addition, we no longer require an attached statement for tip or group-term life insurance adjustments.

4. There is now a checkbox at the top to indicate the quarter the form covers. Line 1 will now ask each quarter for the number of employees on the 12th day of the 3rd month of that quarter.

5. The former line 17, dealing with Federal Tax Liability and deposit requirements, has been completely redesigned into a new Part 2. This has been a major area of confusion in the past and the new format makes it easier to follow the correct steps.

6. There is now a box for entering the date final wages were paid. If your entity ceases to exist, completing this box should eliminate requests for returns for later tax periods.

7. The instructions have been completely redesigned into a modified question and answer format to improve clarity and ease in finding information.

More changes to ease filing burden are coming in 2006. Beginning in that year, many employers will be able to file an annual return instead of the quarterly Form 941. More details will be available in the coming months, and we will publicize this information in the FSLG Newsletter.

If you are currently a Form 941 filer, you should receive the redesigned form in the mail at the normal time. Remember also that you may file electronically; visit www.irs.gov for further information. You can also file by phone using the TeleFile system; see Publication 3950, 941TeleFile - Your Easiest Way to File, for more information.

GUIDANCE SIMPLIFIES PAYER REPORTING, WITHHOLDING FOR PURCHASE CREDIT CARD TRANSACTIONS
BY GERALD MASTERS, FSLG MID-ATLANTIC AREA MANAGER

The Internal Revenue has issued final guidance for payers to comply with information return reporting and backup withholding requirements when paying service providers through purchase (credit) cards. The guidance, provided in the form of two revenue procedures and an amendment

to the regulations, addresses longstanding obstacles to the proper reporting of and withholding on these types of transactions. Purchase cardholders are now provided an optional method for determining which payment card transactions require the filing of a Form 1099 information return. In addition, the Service has finalized regulations enabling payers to determine when a purchase card transaction is subject to backup withholding.

Revenue Procedure 2004-43 (2004-31 I.R.B. 124) finalizes the guidance proposed in 2003 and provides taxpayers that use purchase cards an optional method to determine which merchants' transactions totaling $600 or more are reportable. It classifies nearly 300 business types by Merchant Category Code (MCC), indicating whether they are subject to reporting under sections 6041 and 6041A as predominantly service providers, or exempt from reporting under the exceptions for merchandise, telephone, freight, storage and similar charges provided for in the regulations. Payment card organizations assign the MCCs and typically notify cardholders of these in the monthly account statements. The Revenue Procedure provides additional guidance for situations in which an assigned MCC is not listed or the cardholder believes the MCC is incorrect.

The Revenue Procedure refers to other authority and guidance for information reporting, including the exceptions to reporting for payments to corporations, tax-exempt organizations, and government entities, notwithstanding that the transaction may involve a reportable MCC. The exception for payments to corporations however, does not apply to payments or transactions by federal agencies.

Federal, state and local government taxpayers that use purchase cards will be able to rely on the MCC method to determine reportable transactions for 2004, for which information returns are due February 2005.

The IRS has also amended regulations to provide limited exceptions to the backup withholding requirements under Section 3406 of the Internal Revenue Code, where a payee has failed to furnish a tax identification number (TIN), or notification that a payee TIN is incorrect. Treasury Regulation 31.3406(g)-1(f), effective January 1, 2005, provides that reportable purchase card payments made through a Qualified Payment Card Agent (QPCA) to merchants require backup withholding only after notification to the purchase card holder that the payee/merchant is not a qualified payee. When such notification occurs, i.e. on the billing statement or other periodic report, the backup withholding requirement then applies to transactions occurring after a grace period of 60-days. If backup withholding is required on subsequent transactions, the continued use of the payment card does not relieve the payer of the obligation to withhold.

The regulation further provides that the purchase card organization (Master Card, VISA, etc.), if designated as a QPCA, performs the duties ordinarily performed by the payer including soliciting and validating payees' tax identification numbers. The organization will communicate to the cardholder its status as a QPCA, as well as the merchant TIN and other information in order for the payer to rely upon in complying with information return filing responsibilities. Revenue Procedure 2004-42 describes in detail the process of becoming and the responsibilities of a QPCA.

You can view Revenue Procedures 2004-42 and 2004-43 at www.irs.gov/irb, and the new regulations can be found in Treasury Decision 9136 at http://www.irs.gov/irb/2004-31_IRB/ar13.html. If you have questions, you can contact your FSLG Specialist. A directory is provided at the back of this publication.

ARE WATER AND SEWER FEES DEDUCTIBLE?
BY MARTIN BOSWELL, FSLG SPECIALIST (NORTHEAST)

We often receive inquiries early in the year from cities, villages and towns asking how to figure the percentage of the fees their water/sewer customers pay that is tax deductible on the customers' Federal income tax returns. In some cases, government entities with water authorities provide a calculation to their service recipients advising them that they can deduct 70% to 90% of their water/sewer fees as an itemized tax deduction on Schedule A of Form 1040, U.S. Individual Income Tax Return. In the cases we have reviewed this information is not correct.

Internal Revenue Code (IRC) section 164 permits a deduction for state and local real property taxes. Under Federal law, a tax is an enforced contribution, collected for the purpose of raising revenue to be used for governmental purposes, and not as a payment for a service rendered. In addition, Section 1.164-3(b) of the Treasury Regulations defines “real property taxes” as taxes imposed on interests in real property and levied for the general public welfare, but does not include taxes assessed against local benefits.

Fees for water/sewer services are not imposed on an interest in real property nor levied for the general public welfare. The charges by a water/sewer authority to its customers for water and sewer services are simply fees for a service and do not qualify as a tax. Consequently, no portion of the fees would qualify as a deduction on the customer's income tax return.

The confusion may come from a misunderstanding of Treasury Regulation 1.164-4(b)(1). This regulation states that:

“Insofar as assessments against local benefits are made for the purposes of maintenance or repair or for the purpose of meeting interest charges with respect to such benefits, they are deductible. In such cases, the burden is on the taxpayer to show the allocation of the amounts assessed to the different purposes. If the allocation cannot be made, none of the amount so paid is deductible.”

In some circumstances, the local governments are attempting to calculate the portion of the water/sewer fees that go to maintenance and interest expenses of their systems. That figure is then provided as being tax deductible. The problem is the service fees do not qualify as a tax to begin with so the provisions of 1.164-4(b)(1) do not apply.

Below are some common situations, with the relevant law that clarifies the issue:

1. A water authority charges its customers for water usage based on meter readings.

The charges are not taxes but fees for receipts of water services.
Revenue Ruling 79-201

2. A sewer utility imposes a flat charge for each quarter to all residential customers.

The charges are not taxes but fees for sewer services.
Revenue Ruling 75-346

3. Real estate taxes are increased on all property owners within a municipality to pay for a sewage disposal system.

The taxes are levied for the general public welfare by the taxing authority at a like rate against all property over which the authority has jurisdiction. This is not a tax assessed against local benefits. The increased real estate taxes are deductible under section 164 of the IRC.
Revenue Ruling 74-52

4. Improvements are made by a municipal water authority to expand the coverage area of the water services. Properties that are benefited by the improvements have an assessment added to their property taxes. The amount of the increase is based on the value of the property.

This is an example of a tax assessed against local benefits. According to IRC 164(c)(1) such charges are not deductible except to the extent that they are properly allocable to maintenance or interest charges.

Revenue Ruling 75-455, Revenue Ruling 76-45

In summary, most of the time water and sewer fees are simply fees for services and are not deductible. Water and sewer authorities should use care not to provide information that might lead customers to take an improper deduction on their federal income tax returns. If you have further questions, contact your local FSLG Specialist. A directory is provided at the back of this newsletter.

IRS ISSUES CAUTION ON PARKING BENEFIT PROGRAMS
BY DENISE Y. BOWEN, FSLG TAX LAW SPECIALIST

Government entities that provide excludable parking benefits to employees should be aware of new published guidance that addresses a type of arrangement that has emerged in recent years. On October 1, 2004, The Treasury and Internal Revenue Service (IRS) issued guidance to prevent an abusive employment tax arrangement in which an employee benefits from both a salary reduction on a pre-tax basis and a tax free reimbursement for parking expenses. These transactions result in a “double-dip” arrangement in which the same expense receives tax-favorable treatment twice.

In Revenue Ruling 2004-98, the IRS explains that employer provided qualified parking benefits within the statutory limits are excluded from gross income and are not subject to federal income tax (FIT) withholding, social security and Medicare (FICA) taxes and the federal unemployment tax (FUTA). Employers may provide qualified parking benefits on a pre-tax basis through a salary reduction agreement or by cash reimbursement made under a bona fide reimbursement plan.

The ruling clarifies, however, that employer reimbursements for parking are not excludable from income and wages for employment tax (FIT withholding and FICA taxes) purposes where the parking has already been paid on a pre-tax basis. A salary reduction election by an employee is treated as an employer-provided benefit. Because pre-tax parking is treated as a benefit provided by the employer, and not the employee, there is no expense incurred by the employee to reimburse.

The IRS and Treasury have acted promptly to eliminate the transaction described in Revenue Ruling 2004-98 as well as other double-dip arrangements involving attempts to exclude alleged reimbursements of the cost of nontaxable benefits that are provided by employers on a pre-tax basis. This prompt action enables responsible taxpayers and their advisors to avoid involvement in future double-dip arrangements.

Background
Internal Revenue Code (IRC) §132(a)(5) provides that any employer-provided fringe benefit is a “qualified transportation fringe” is excluded from gross income. In addition, for purposes of FICA, FUTA, and FIT withholding, the definition of “wages” does not include any benefit provided to or on behalf of an employee if, at the time such benefit is provided to or on behalf of an employee, it is reasonable to believe that the employee will be able to exclude such benefit from income under §132. IRC §§ 3121(a)(20), 3306(b)(16), and 3401(a)(19).

A qualified transportation fringe benefit is any of the following provided by an employer to an employee: (1) transportation between home and work in a commuter highway vehicle, (2) a

transit pass, or (3) qualified parking. IRC §132(f)(1). IRC § 132(f)(5)(c) defines qualified parking, in part, as “parking provided to an employee on or near the business premises of the employer…”

The Taxpayer Relief Act of 1997 clarifies that for taxable years beginning after December 31, 1997, qualified parking includes parking that is provided in lieu of compensation otherwise includible in gross income, and that no amount is includible in gross income solely because an employee can choose between qualified parking and compensation. IRC § 132(f)(4). As a result, beginning January 1, 1998, employees are permitted to make salary reduction elections to receive tax-free employer-provided qualified transportation fringe benefits not in excess of the statutory limits.

A qualified transportation fringe benefit may also be provided in the form of a cash reimbursement. IRC § 132(f)(3). The Regulations provide that a reimbursement must be made under a bona fide reimbursement arrangement in order to be excluded from gross income. Employers that make cash reimbursements must establish a bona fide reimbursement arrangement to ensure that their employees have, in fact, incurred expenses for qualified parking, and implement reasonable procedures to ensure that an amount equal to the reimbursement was incurred by the employee for qualified parking. §1.132-9(b) Q/A-16(a)/ (c).

The Facts
The issue in Revenue Ruling 2004-98 is “whether, under the facts described below, the exclusion from gross income under §132(a)(5) applies to payments from an employer to employees characterized as 'reimbursements by the employer'.”

As an example, the Revenue Ruling provides the following scenario:

Employer X decides to provide parking for its employees. The parking will be on or near X's business premises. Before X implements the arrangement for parking, as described below, X pays Employee A monthly wages of $1,500. After withholding for employee FICA tax of $114.75 and withholding for FIT of $83.80, A's net pay is $1,301.45.

Monthly wages	$1,500.00
FICA tax withholding	(114.75)
FIT withholding	(83.80)
Net monthly payment	$1,301.45

X implements a payroll arrangement under which the amount of its employees' cash compensation is reduced in return for X providing parking. In addition, X makes “reimbursement” payments to employees with respect to parking expenses in amounts that cause employees' net after-tax pay from X to be the same amount as it would have been if there was not compensation reduction. X takes the position that both the compensation reduction amounts and the “reimbursement” payments are excluded from gross income of employees and are not subject to FICA or FUTA tax and FIT withholding.

X can make the compensation reduction used to pay for parking under X's payroll arrangement mandatory or elective. For example, X could unilaterally reduce all employees' salaries and provide parking to all employees. Alternatively, X could offer employees the choice, as permitted under section 132(f)(4), between cash compensation and parking, and provide parking to the employees electing to reduce their cash compensation.

After X implements the arrangement, Employee A's monthly wages of $1,500 are reduced by $100 in exchange for the parking. From the remaining $1,400, X withholds employee FICA tax of $105 and FIT of $73.30. X then pays A an additional $79.75 as a purported reimbursement of parking expenses, with the result that A's net pay remains at $1,301.45.

Monthly wages	$1,400.00
FICA tax withholding	(105.00)
FIT withholding	(73.30)
Subtotal	$1,221.70
Additional payment	79.75
Net monthly payment	$1,301.45

Conclusion

The ruling concludes that based upon the facts, the employer's position that such payments are excludable reimbursements of qualified parking expenses is meritless.

The ruing explains that if an employee is given a choice, and elects a non-taxable fringe benefit in lieu of compensation, or if an employer unilaterally reduces an employee's cash compensation for the purpose of providing a non-taxable fringe benefit, the benefit is treated as an employer-provided benefit. As a result, the cost of providing the qualified parking benefit is incurred by employer X, there is no expense incurred by employee A to reimburse, and the reimbursement payment that X makes to A is not excluded from gross income under §132(a)(5) or from wages for employment tax purposes.

The conclusion is the same whether the compensation reduction was mandatory or elective, or if the employer originally provided free parking to employees and upon implementing the payroll arrangement purported to impose a charge on employees for parking. This is the outcome whether or not the arrangement is invisible to the employee whose take home pay remains unchanged.

Finally, the ruling notes that the conclusion is applicable to “arrangements with respect to benefits other than parking where: (1) an employee's salary (and gross income) is reduced in return for a non-taxable benefit, and (2) the employer 'reimburses' the employee for some or all of the cost of the non-taxable benefit and excludes the reimbursement from the employee's salary (and gross income) even though that cost was paid by the employer and not the employee.”

Your local FSLG Specialist can help you if you have questions about this ruling. See the directory at the back of this newsletter.

Federal, State and Local Governments Contacts

State	Specialist	Telephone Number	Ext.
Alabama	Judy Nichols	(251) 340-1781	
	John Givens	(251) 340-1761	
Alaska	Gary Petersen	(907) 456-0317	
Arkansas	Jan Germany	(501) 324-5328	253
Arizona	Kim Savage	(928) 214-3309	5
California	Gordon Parker	(909) 388-8161	
	Phyllis Garrett	(213) 576-3765	
Colorado	Karen Porsch	(719) 579-0839	231
	Chuck Sandoval	(303) 446-1156	

Connecticut	Phyllis Burnside	(401) 525-4205	
Delaware	Kevin Mackesey	(302) 856-3332	12
Florida	Sheree Cunningham	(727) 570-5526	440
	Fernando Echevarria	(954) 423-7406	
	Paulette Leavins	(904) 220-6764	
	Mae Whitlow	(407) 660-5822	293
Georgia	Denver Gates	(404) 338-8205	
Hawaii	Sue Ann Jansen	(503) 326-5057	
Idaho	Karen Porsch	(719) 579-0839	231
Illinois	Ted Knapp	(618) 244-3453	
	Joyce Reinsma	(312) 566-3879	
	Janie Smith	(630) 493-5148	
Indiana	Valerie Hardeman	(317) 226-5305	
Iowa	David Prebeck	(515) 573-4120	
Kansas	Gary Decker	(316) 352-7475	
	Allison Jones	(316) 352-7443	
Kentucky	Ray McLennan	(270) 442-2607	127
Louisiana	Gloria Brooks	(225) 389-0358	
	Robert Lettow	(318) 869-6312	119
Maine	Bob Westhoven	(207) 784-6988	
Maryland	James A. Boyd	(410) 962-9258	
Massachusetts	Mark A. Costa	(617) 320-6807	
Michigan	Daniel Clifford	(313) 628-3109	
	Lori Hill	(906) 228-7831	
Minnesota	Pat Wesley	(218) 720-5305	225
Mississippi	John Givens	(251) 340-1761	
	Robert Lettow	(318) 869-6312	
Missouri	Joe Burke	(636) 940-6389	
	Sharon Boone	(417) 841-4535	
Montana	Katherine Dees	(406) 761-1825	229
Nebraska	Thomas Goman	(402) 361-0202	
Nevada	Gordon Parker	(909) 388-8161	

New Hampshire	Bob Westhoven	(207) 784-6988	
New Jersey	Pat Regetz	(908) 301-2119	
New Mexico	Toni Holcomb	(505) 527-6900	232
New York	Martin Boswell	(315) 233-7302	
	Fran Reina	(315) 793-8171	
North Carolina	Clifford Brown	(803) 253-3523	
North Dakota	Al Klaman	(701) 227-0133	
	Rhonda Kingsley	(701) 239-5400	261
Ohio	Trudee Billo	(419) 522-2359	
	Amy Genter	(419) 522-2259	
Oklahoma	Pat O'Neil	(405) 297-4895	
Oregon	Marilee Basaraba	(503) 326-5030	
	Sue Ann Jansen	(503) 326-5057	
Pennsylvania	Patricia Crawley	(215) 861-1364	
	Doug Siegert	(412) 395-4871	
	Nora Bliven	(717) 291-1991	118
Rhode Island	Phyllis Burnside	(401) 525-4205	
South Carolina	Clifford Brown	(803) 253-3523	
South Dakota	Marlyce Luitjens	(605) 226-7216	231
Tennessee	Ray McLennan	(270) 442-2607	127
Texas	Oliverio Martinez	(972) 308-1180	
	Steve O'Brien	(512) 464-3120	
	Robert Jackson	(281) 721-7993	
	Susan Serrano	(512) 499-5435	
Utah	Katherine Dees	(406) 761-1825	229
Vermont	Fran Reina	(315) 793-8171	
Virginia	Eugenia Bahler	(703) 285-2350	138
	Michael Durland	(540) 887-2600	18
Washington	Clark Fletcher	(425) 489-4042	
West Virginia	Michael Durland	(540) 887-2600	18
Wisconsin	Susan Borchardt	(414) 297-1672	
	Ruthann Watts	(262) 513-3520	
Wyoming	Dwayne Jacobs	(307) 672-7425	33

TAX EXEMPT BONDS: WHY WOULD WE NEED TO FILE AN INFORMATION RETURN WHEN WE DID NOT ISSUE BONDS?
BY LYNN KAWECKI, TEB TAX LAW SPECIALIST

Frequently, small issuers and sometimes large issuers are surprised to learn that they have issued bonds in a particular case. It is more of a surprise that they have actually filed a Form 8038-G or 8038-GC with the IRS, only late. The biggest surprise is that invariably the person on the phone is the one that has signed the form.

All government entities that issue bonds are required to file information returns (Form 8038, 8038-G, or 8038-GC) concerning a bond issuance. Failure to file the return may cause interest on the bonds to be taxable. This is a straight-forward requirement generally adhered to by issuing agencies. Failure to satisfy the requirement is generally through inadvertence. However, issuers do not always recognize when an issuance occurs.

Under the Internal Revenue Code (IRC), any obligation for which a state or local government pays interest, is a bond. This is certainly much broader than the more familiar but formal process of issuing bonds. A frequently encountered situation occurs when a local government buys an expensive item through an installment sales contract, rather than issuing bonds and purchasing the item outright. Commonly, local governments buy fire trucks through installment sales contracts. There is little difference in the two types of transactions. In both cases the local government borrows money and pays interest to purchase the fire truck. Thus, both are bond issuances that require the filing of a Form 8038-G or 8038-GC.

Even if an issuing authority intends to file an information return for each installment sale it enters into, it still may miss a disguised lease-purchase arrangement. Many issuers lease office equipment such a copiers or mail metering machines. The vendors of this equipment sometime package the transaction in such a way that the lease includes an installment sale less the trade-in value plus the payment of interest. Structuring the transaction in this manner allows a vendor to deduct the interest portion of the payments received.

The problem with this type of transaction is that the state or local government may not recognize that it is paying interest or that it must file the required information return for that issuance. In fact, many issuers believe that they are still leasing the equipment. Generally, objective facts support their conclusions. The issuers pay level payments for a short period of years and at the end of the term the old machine is replaced with a new machine. This is typical of the lease arrangements that they have had for years. Information provided by issuers demonstrates that vendors may informally refer to the transaction as a lease and not a sale. This further supports the issuer's belief that the transaction is a lease.

Nonetheless, when a vendor correctly structures the transaction, it is a lease with an installment sale component, regardless of how the issuer characterizes it. The issuer is responsible for making the required filing. Since the vendors benefit from the structure of the transaction, they often assist an issuer in meeting the filing requirements. In fact, vendors keep the IRS form signed by the issuer and send it to the IRS when due. Unfortunately, vendors often miss the filing due dates. Nearly 300 information returns involving lease purchase transaction were filed late this last fiscal year.

It is important for issuers to remember that they have the responsibility of making the required filing for any issuance in a timely manner. Gratuitous assistance from vendors cannot relieve issuers of their responsibility. The trend is that more and more vendors structure transactions as lease-purchases to take advantage of the tax benefits. Accordingly, issuers need to be aware of obligations they have as issuers.

Finally, not every lease arrangement may be a bond issuance. Issuers must actually pay interest under the transaction for there to be an issuance of bonds. If the transaction is truly a lease, the vendor will have no right to exclude any portion of the payments as tax-exempt interest. Issuers should have the structure of the transaction clearly explained so that they will know whether they pay and interest under the transaction. If they pay interest, they should also require explanations of what their reporting responsibilities are under the IRC. Such knowledge may protect governmental entities from avoidable surprises in the future.

For more information about Tax Exempt Bonds, visit the site at www.irs.gov/bonds or contact Clifford Gannett, Manager of Tax Exempt Bonds Outreach Planning and Review at 202-283-9881, or Lynn Kawecki at 202-283-9782.